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Connecting Market Leaders with Investors

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THE WALL STREET TRANSCRIPT**

## **ANALYST INTERVIEW**

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## U.S. Banking Sector to Continue Outperformance in 2017

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**CHRISTOPHER WHEELER** is a U.S. Banking Analyst at Atlantic Equities LLP. Mr. Wheeler joined Atlantic Equities LLP in 2015, bringing extensive experience to its bank coverage. A qualified Chartered Accountant, Mr. Wheeler held a number of planning roles at Barclays Bank in the 1980s before becoming its first Head of IR. He joined Lehman Brothers in 1988 to cover European banks and has subsequently had senior bank research roles at Fox-Pitt, Kelton, Bear Stearns and Mediobanca.

## SECTOR — BANKING

(AGT802) **TWST:** Can you tell us your role within your firm and give us a sense of what your coverage is?

**Mr. Wheeler:** I am an Equities Analyst who covers U.S. banks, including **JPMorgan** (NYSE:JPM), **Citigroup** (NYSE:C), **Bank of America** (NYSE:BAC), **Wells Fargo** (NYSE:WFC), **Goldman Sachs** (NYSE:GS), **Morgan Stanley** (NYSE:MS), **U.S. Bancorp** (NYSE:USB) and **PNC Financial** (NYSE:PNC) as well as **American Express** (NYSE:AXP) and **First Republic Bank** (NYSE:FRC).

**TWST:** Can you give me a general outlook on that coverage for the next 12 months?

**Mr. Wheeler:** The general outlook has clearly changed quite dramatically since the U.S. elections, and we have seen U.S. bank stocks rally quite strongly, and it seems that the outlook for the sector, which has been an underperformer for most of 2016, is that it is going to continue to outperform on the back of rising rates, which is clearly beneficial to net interest margins. There is also likely to be a pickup in lending volumes, especially in the consumer sector if the incoming administration delivers on its promises of reflationary measures. In addition, the capital markets look set to benefit from a stronger growth profile in the U.S., capitalizing on the better tone to trading markets following the U.K.'s vote to leave the EU in June. This will help the universal banks and the investment banking-focused stocks.

**TWST:** Can you expand a little bit on both the U.S. election result as well as Brexit, and give us a sense of what the

market trends are in response to them as well as your thinking about how the markets are reacting to both of those events?

**Mr. Wheeler:** If we combine, if you will, the Brexit vote in June and the U.S. presidential election result in November, what we saw was a high degree of volatility around both foreign exchange and interest rates, and that clearly had a really beneficial impact on what the banks call their macro businesses within fixed income. This was fueled by corporate customers much more active in hedging interest and foreign exchange. In addition, we saw a pickup in debt capital markets activity.

In terms of the U.S. election, as we noted earlier, the market expects the incoming administration to provide a number of stimulants to the market which will boost growth. In addition to boosting trading revenues, a better domestic environment may provide a spur to M&A activity, which slowed in H1 2016, but has recently picked up again. The rhetoric around lower tax rates and the removal of the tax-inversion limitations may fuel M&A in 2017. Equity capital markets, which have been quite weak, should also benefit from improved sentiment, including the fact that the markets have breached or are approaching new highs.

In terms of equity trading, the third quarter was not a great quarter because of muted volumes, and it was

being compared to the very volatile Q3 2015. However, we have seen flows into equity funds accelerate since the election, and the better tone to the market should spill over into 2017. In terms of the banks' more traditional lending operations, we have had a rate rise in December 2016 and look set for possibly three more rate

## Highlights

*Christopher Wheeler covers U.S. banks. Mr. Wheeler says the outlook for the sector is that it is going to continue to outperform on the back of rising rates. He says there will also likely be a pickup in lending volumes. Mr. Wheeler adds that U.S. banks have been successful in controlling costs by reducing staff and looking at areas of digitization.*

*Companies discussed: JPMorgan Chase & Co. (NYSE:JPM); Citigroup (NYSE:C); Bank of America Corp (NYSE:BAC); Wells Fargo & Co (NYSE:WFC); Goldman Sachs Group (NYSE:GS); Morgan Stanley (NYSE:MS); U.S. Bancorp (NYSE:USB); PNC Financial Services Group (NYSE:PNC); American Express Company (NYSE:AXP); First Republic Bank (NYSE:FRC); Barclays PLC (ADR) (NYSE:BCS) and Deutsche Bank AG (USA) (NYSE:DB).*

rises in 2017. This will certainly benefit the depressed net interest margins that have been pushed down during this “lower-for-longer” environment. It may also act as a dampener on new lending, especially in the mortgage markets where refinancings have collapsed as the yield curve has steepened. However, if the incoming administration is successful in boosting economic growth, this will counter the impact of rising rates in terms of loan volume.

**TWST:** What’s the talk there about how Brexit is going to impact London as a financial center and then subsequently its relationship with the U.S. banks? What’s your own opinion about that talk?

**Mr. Wheeler:** I have a strong position. People are being far too sanguine about London’s position as a leading financial center, including many people who have been strong supporters of Brexit. I don’t think they realize the impact it is going to have on the large international banks in London, not just on the U.S. banks, but many of the foreign banks. Only last week, there was a suggestion in the media that the large Japanese banks are all looking to move their domicile to elsewhere within the EU to retain unfettered access to the single market. I am sure the Chinese and Russian banks are also assessing their options. In terms of more concrete evidence of this, we have already had indications that **Citigroup** is already shifting staff from London to Dublin.

I think that it is inevitable that London will be weaker as a financial center. I cannot imagine why anybody would think that will not be the case. Some are arguing that Europe needs London’s financial services expertise. To a degree that is true, but while London will still play a major role in Europe’s financial services industry post Brexit, the extent of its leadership will inevitably be eroded. If the U.K.’s financial services does retain unrestricted access to the European market, that will almost certainly come at the cost of retaining freedom of movement into the U.K., and that would cause some major political problems, as removing this was a key plank of the successful campaign to leave the EU.

If that access to the whole of the EU market is not obtained, international banks will have to move staff to EU locations, and U.K. banks will have to follow suit if they want to be able to service clients in countries remaining within the U.K. There is inevitably going to be an impact. The U.S. banks see this as an opportunity suggesting that business will migrate from London to New York. In summary, I think London will remain one of the world’s leading financial centers, but I do not see how it will not lose ground to other markets once Brexit has been completed.

**TWST:** Is there talk about what the British or the U.S. government could do to stem the tide of outgoing banking business?

**Mr. Wheeler:** It is difficult. Once again, today we have had yet another challenge as to whether or not the U.K. would automatically move out of the free-trade zone as a result of leaving the EU, because there are other countries such as Liechtenstein, Iceland and Norway that are still within the free-trade zone but are

not members of the EU. The problem with this, as I have already noted, is that it will involve allowing freedom of movement of labor.

I am embarrassed to say that the vote by the U.K. to leave the European Union was based on immigration, which I consider rather sad. As a consequence, if the government tries to negotiate Brexit but still allows the freedom of movement throughout the U.K. and EU, it will be a major issue. I am not sure the government fully understands how strong the feelings on this matter are outside of London. There really is a parallel you could argue with where Donald Trump obviously gained a large portion of his votes. People are

perhaps dissatisfied with the current status quo, with urban elites ignoring the concerns of the broader population.

**TWST:** What other trends are you monitoring personally and within banking obviously?

**Mr. Wheeler:** The big discussion for the last three years has been around costs, because with revenues challenged and slow economic growth, the one thing the banks could do was control costs. The U.S. banks in particular seem to have been very successful in this area. To illustrate some of the actions taken, **Goldman Sachs** now has 25% percent of its staff in either Salt Lake City, Bangalore or Warsaw. This has obviously considerably reduced its cost base. If you look at **American Express**, there has been a massive reduction of bank office staff in more expensive U.S. locations.

**“People are being far too sanguine about London’s position as a leading financial center, including many people who have been strong supporters of Brexit. I don’t think they realize the impact it is going to have on the large international banks in London, not just on the U.S. banks, but many of the foreign banks.”**

1-Year Daily Chart of Goldman Sachs Group, Inc.



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

There are a number of areas of costs the banks are looking at including premises costs and travel and entertainment, but another factor is now digitalization, which is affecting the whole of the banking sector. One of the interesting aspects is the digitalization, or should I say, the electrification of fixed income trading which is finally becoming a reality. It has been something that has been a block for the banks for quite a long time. They electrified a large part of the equity market some time ago, but replicating this in fixed income was seen as much more complex given how many debt instruments exist for each issuer.

But of course, digitalization means creating algorithms to allow one to trade those electronically, and it means that we are seeing another area where the large trading banks can make further substantial reductions in cost.

**Goldman Sachs'** former President, Gary Cohn, noted that while **Goldman Sachs** had shed 10% of its fixed income trading staff, it has cut compensation costs by 20%. What **Goldman Sachs** has done is replace expensive traders with technology, and its peers are following suit. You have the same thing in retail banking. It is fair to say that the U.S. compared to Europe is behind the curve on digitalization, but are playing catch-up. The introduction of ChasePay during the course of summer was an important move, with **JP Morgan** accompanying it with the launch of its Sapphire Card. **JP Morgan** used the card to boost the use of its new electronic wallet, and while this is not without a cost in terms of customer rewards, the cost of processing transactions through this medium is tiny.

The banks are regularly talking about how much more business is being done by the client digitally. However, despite this fact, there is a massive reluctance in the United States to close branches. **Wells Fargo**, for example, continues to talk about how important the branch is in signing up a client to new products. However, I think the U.S. banks will have to creative in this area. To illustrate, in the U.K., **HSBC** has come to an agreement with the post office, which still has a big branch network, that the post office will cash **HSBC's** checks and take deposits on its behalf. This gives **HSBC** the ability to close a branch in certain towns but still ensuring clients can carry out their business locally.

However, this leads us onto the issue of cybersecurity. A few weeks ago **Tesco Bank** in the U.K., a big supermarket that has quite a big retail banking business, had a number of its clients' accounts hacked and money withdrawn. I call cybersecurity "the son of compliance," because while we have seen a massive escalation in compliance costs since the crisis, as these costs recede as the banks become more efficient in managing compliance, so the cost of cybersecurity increases.

Another concern remains the health of the European banking system, because it is a worrying issue. I have been talking about it for probably three years now. The U.S. banks have obviously been taking more and more share of the global investment banking fee pot, and the big question that market watchers are asking is whether it is healthy for investment banking markets in Europe to be dominated by U.S. banks. The EU is aware of this problem and is talking of moving toward a structure that mirrors the one introduced by the Fed, whereby foreign banks operating in the U.S. — with our \$50 billion of assets in the U.S. — have to operate through bank holding companies. These holding companies will have to be locally capitalized this is a process that is proving expensive for **Barclays** (NYSE:BCS) and **Deutsche Bank** (NYSE:DB) at present. If the EU requires **Goldman Sachs**, **Morgan Stanley** or **JP Morgan** to follow suit in Europe it would not prove popular.

**TWST: How would you characterize the current**

**conversation on the size of some of the U.S. banks you cover? Do you think that a lot of the fear around them, as the regulatory screws have tightened, is going away to some degree?**

**Mr. Wheeler:** The Fed has done a great job, in my opinion. There is no doubt about it. The U.S. banks are looking very strong. The stress-testing methodology is superior to the European one, much more robust. There is also a higher degree of transparency. It is really a high degree of comfort.

It is also worth noting that the U.S. banks went into the crisis with stronger balance sheets, as the Fed did not implement Basel II, which allowed banks to use internal models to calculate risk-weighted assets. In contrast, the European banks were allowed to adopt Basel II and used this mechanism to effectively reduce the amount of capital they had to hold. However, regardless of the good work of the Fed, I am not sure the issue of "too big to fail" has gone away. This was illustrated in September, when the U.S. Department of Justice said they were seeking a settlement with **Deutsche Bank** of \$14 billion in respect of its MBS activity in the U.S. precrisis. This was far higher than the market expected and saw a sharp decline in **Deutsche Bank's** share price. This in turn saw bank share prices in general, including in the U.S., tumble.

The worry was the contagion that would occur if **Deutsche Bank** was forced to ask for government assistance. You could argue this was a replay of what happened when Lehman Brothers moved into bankruptcy in 2008. In the event, **Deutsche Bank** was able to point to the stability of its deposit base and its high levels of liquidity, and this saw markets stabilize. However, it bought home the fact that if any large bank runs into trouble, the problem quickly spreads. This has provided plenty of ammunition for the politicians in the U.S. who continue to worry about the sheer scale of some of their banks.

***"The banks are regularly talking about how much more business is being done by the client digitally. However, despite this fact, there is a massive reluctance in the United States to close branches."***

**1-Year Daily Chart of JPMorgan Chase & Co.**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: What do you think has to happen to respond now to the markets? Do you think there is a further need mitigate against some of the big ripple effects possible with some**

of the banks?

**Mr. Wheeler:** A bank like **JP Morgan** has a fortress balance sheet; that is well-known. I think **Deutsche Bank** had \$500 billion of liquidity and \$500 billion more of deposits. You had a position on the balance sheet. But if people worried about its capital, then people worried about what was going to be allowed to go bust because of the way the Europeans bailing laws work, etc. What it brought home was a ridiculous fear to have that the German government would somehow engineer a rescue of its biggest bank.

I hate to say it: Despite all the great work that has been done and how much the stronger and robust the banks are, the market can still start to react given that **Deutsche** had the \$18 billion fine from the Department of Justice. One has to ask the question of how comfortable the Department of Justice was putting **Deutsche** in play, which is what it did by asking for that money. **Deutsche** could not afford to pay \$18 billion without having to go to a panic capital issue with a massive 50%-plus discount to existing shareholders.

It is just difficult to see that if something like that started to chase one of the big U.S. banks, that there would not be the same fear and concern for the market because of the sheer scale and interconnectedness. Again, I am not criticizing the U.S. banks; rather I am saying the balance sheets are really strong, but I am also saying that most of **Deutsche Bank's** balance sheet was exceptionally strong, and it did not stop the market going after **Deutsche** and then subsequently causing an impact on the U.S. and big international banks that are exposed to **Deutsche Bank** just by the nature of their businesses.

**TWST: Can you drill down on some of the banks you cover and talk about who you think is functioning the best?**

**Mr. Wheeler:** We had a situation in the middle of 2016 where you could have argued, if you want to buy a universal bank, you buy either **Wells Fargo** or **JPMorgan** as they are both great businesses and both are on a yield of around 3%. **JPMorgan** has more investment banking, but on the other hand, **Wells Fargo** is building an investment bank. **JPMorgan** has a much stronger asset management business. They both have very strong balance sheets and good management. However, the legal and regulatory problems that **Wells Fargo** is now facing and the loss of revenue that is an inevitable consequence of the need to pull back on cross-selling in the community bank will act as a drag on the share price despite the improved outlook for interest rates in the U.S. We do not think these concerns will lift until the Investor Day in May, when **Wells Fargo** can lay out its revised strategy for the community bank.

Elsewhere, despite the rally in bank stocks since November, **Bank of America** and **Citigroup** still look good value based on rising rates, a better environment for capital markets activity and the incoming administration's promise to reduce the corporate tax rate. We think the two capital markets-focused banks, **Goldman Sachs** and **Morgan Stanley**, look up with events, but if trading gets off to a good start in 2017, they will benefit from the fact that they have restored operational leverage in their businesses, with **Goldman Sachs** probably in a stronger position.

A bank we do remain very positive on is San Francisco based **First Republic Bank**. It specializes in lending to wealthy individuals

and now has over \$80 billion of AUM in its wealth management unit. It is a remarkably focused bank that is very well-managed.

Finally, I remain cautious on **American Express** because while I think that it is a very good business and a very fine brand, it is suffering from very fierce competition from the large banks. Warren Buffett, a large shareholder in the company, noted this in his annual shareholder letter in 2016. The problem is that the credit card business earns an ROE in excess of 20%, and with banks still struggling to get above 10% in their broader business, it should be no surprise they are investing in their card businesses.

**TWST: Outside of what all that you just covered, what do you think is either underappreciated or misunderstood at the moment about your coverage?**

**Mr. Wheeler:** What is misunderstood is that there is still some confusion as to exactly what 50, 75 or 100 basis points in rates really does to bank margins. There is confusion over how quickly you can pass that on to your borrowing clients and how long you can delay passing on the benefit to your deposit. Most of the big U.S. banks, particularly **JPMorgan**, **Wells Fargo** or **Bank of America**, now have far more deposits than loans. That is a very secure thing to have. Obviously loan to deposit ratio in the 50s or 60s is not really good for the bank in many ways because they would be better off lending those deposits, because that is how you are supposed to make money.

The problem is that, at the moment, a lot of those deposits are interest-free. They are checking accounts for individuals and commercial companies who are just not bothered about having their liquidity sitting there in a bank account. The question is at what time those depositors consider moving their funds out of deposits into money market accounts. There will be some dilution as a result of having to pay more for deposits, but then, in addition to that, we have to face the fact that if rates rise, bad debts will rise.

We have gone through a very benign period for credit. Obviously there have been a lot of recoveries from losses that were made during the crisis in the commercial loan books, but I think that we are going to see a situation whereby we are going to start seeing bad debts ticking up toward the end of next year just by the nature of people getting used to the cheap cost of borrowing and that scenario changing as rates rise. In addition, I do not think that any rise in net interest margins will not generate an increase in overheads. The way people are rewarded in banks means inevitably that some of that gain will go into performance pay.

**TWST: Is there anything else you wanted to add?**

**Mr. Wheeler:** I think we have gone over enough.

**TWST: Thank you. (KJL)**

*Note: Opinions and recommendations are as of 11/28/16.*

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